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Department of the Treasury
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Person To Contact:
, ID No.

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Refer Reply To:
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LEGEND

Settlor	-
Trust	-
Daughter	-
Grandchild 1	-
Grandchild 2	-
Spouse	-
Great Grandchild 1	-
Great Grandchild 2	-
Date 1	-
Date 2	-
Date 3	-
Date 4	-
Date 5	-
Date 6	-
Year 1	-
Year 2	-
Year 3	-
Year 4	-
Court	-
Trustee	-
State	-
State 1	-
Code	-
Cite 1	-
Cite 2	-

Cite 3 -
Cite 4 -
Cite 5 -
Cite 6 -

Dear :

This is in response to a letter dated June 8, 2006, submitted by your authorized representative, requesting rulings under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

FACTS

Settlor died on Date 2, a resident of State 1. Item Four of Settlor's will (Will), dated Date 1, established a trust (Trust) for the benefit of Daughter and her descendants. Trust provided that the trustee would pay the net income to Daughter for her life. The trustee was authorized to make principal distributions to Daughter to provide for her support and maintenance and to Daughter's children to provide for their support, maintenance, and education.

Upon Daughter's death, the trustee would expend the net income for the support, maintenance, and education of Daughter's children. When a child reaches age 25, the trustee may pay the income directly to the child. Trust also provides that distributions of principal may be made to Daughter's children for their support, maintenance, and education.

Upon the death of Daughter and a child of Daughter, the children of such child of Daughter is entitled to receive such part of the corpus of Trust as an equal division between Daughter's children would represent; the children of Daughter to represent the number of shares into which the corpus of Trust is to be divided, and the children of such children to take the share so represented by the parent.

Daughter had two children, Grandchild 1 and Grandchild 2. Grandchild 2 has two children, Great-Grandchild 1, born and adopted in Year 1, and Great-Grandchild 2 born in Year 2. Grandchild 1 died in Year 3, survived by three children. Daughter died in Year 4. Upon the death of Daughter, Trust was split into two equal shares. One share was distributed to the children of Grandchild 1 and the other share is held in Trust. Trustee pays the net income of Trust to Grandchild 2 every month.

Trust became irrevocable on Settlor's death, Date 2, which is prior to September 25, 1985, and it is represented that no additions have been made to Trust after Date 2.

Trust does not define whether "child" or "children" includes an adopted child or children. When Trust was established, State law presumed that bequests to "children"

were intended for natural children, which would exclude adopted children. Cite 1. Effective , State law provides that the rules of construction or presumption provided in the Act applies to a governing instrument executed before that date unless there is a clear indication of a contrary intent. Cite 2. State law provides that, in construing dispositive provisions of a transferor, an adopted individual is included in class gifts. Cite 3. For purposes of intestate succession, State law provides that an adopted individual is the child of his or her adopted parents. Cite 4.

As written, Trust does not include any language regarding the rule against perpetuities. Grandchild 1 was alive at the time of Settlor's death. Grandchild 2 was born after Settlor's death. Because Grandchild 2 was not alive upon Settlor's death, Grandchild 2 cannot be a measuring life. Under State law, if a nonvested property interest may be invalid under State law, then upon the petition of an interested party, a court shall reform a disposition in the manner that most closely approximates the transferor's manifested plan of distribution that is within the 90 years allowed by the sections set forth in the State law. Cite 5.

Settlor was a resident of State 1 when he died. Trust has been administered in State 1 since Settlor's death. The trustee is Trustee, a corporate successor to the trustee, and located in State 1. However, the beneficiaries, vested or contingent, of Trust are not residents of State 1. Grandchild 2, Great-Grandchild 1, and Great-Grandchild 2 are residents of State. None of the Trust assets consist of tangible personal property or real property. Accordingly, on Date 4, the parties petitioned State Court pursuant to Cite 6, which provides that on petition of an interested person, the court may approve an interpretation, construction, modification, or other settlement that is agreed upon in writing by all presently identified and competent beneficiaries whose interests in the trust may be affected to resolve a contest, controversy, or question of construction or interpretation concerning the existence, administration, or termination of an irrevocable trust. The court shall approve the agreement if it appears to have been reached in good faith and its effects are just and reasonable under all of the relevant facts and circumstances. Cite 6.

On Date 3, Grandchild 2, Great-Grandchildren 1 and 2, and Grandchild 2's spouse, Spouse, entered into an agreement (Settlement Agreement), as described above. The Settlement Agreement states (i) that Trust is held for the benefit of Grandchild 2 and his children and that Grandchild 2 has a life estate in Trust, with a remainder distributable to his children; (ii) on the death of Grandchild 2, Trust will terminate and the remainder will be distributed per stirpes to the surviving children of Grandchild 2, and for purposes of State law, Grandchild 2 is the designated ancestor and his children are Great-Grandchild 1 and Great-Grandchild 2; (iii) that the remainder interest will vest on the earlier of the death of Grandchild 2 or one day before the 90th anniversary of the death of Settlor, Date 6; and (iv) the laws of State apply to Trust.

On Date 5, Court signed a conditional Order modifying Trust as described above, subject to receipt by the petitioners of the rulings, set forth below, from the Internal Revenue Service.

You have asked for the following rulings:

(1) the Court order interpreting Trust as including adopted children as “children” does not constitute a modification of Trust for purposes of § 2601 and resulting distributions from Trust consistent with this interpretation will not result in the loss of Trust’s exempt status for purposes of the generations-skipping transfer tax;

(2) the Court order interpreting Trust as providing a life estate for Grandchild 2, with the remainder to Great-Grandchild 1 and Great-Grandchild 2, does not constitute a modification of Trust for purposes of § 2601 and resulting distributions from Trust consistent with this interpretation will not result in the loss of Trust’s exempt status for purposes of the generation-skipping transfer tax;

(3) the Court-approved Settlement Agreement does not result in a gift by any party to the agreement;

(4) the Court order interpreting Trust as including adopted children as “children” and resulting distributions from Trust consistent with this interpretation will not result in a gift by any party to the agreement;

(5) the Court order interpreting Trust as providing a life estate for Grandchild 2, with remainder to Great-Grandchild 1 and Great-Grandchild 2, and resulting distributions from Trust consistent with this interpretation will not result in a gift by any party to the agreement;

(6) no party to the Court-approved Settlement Agreement will realize gain or loss as a result of entering into the agreement;

(7) Trust is not includible in Grandchild 2’s gross estate under § 2033.

LAW AND ANALYSIS

Rulings ##1 and 2

Section 2601 imposes a tax on every generation-skipping transfer, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping

Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) The settlement is the product of arm's length negotiations; and (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) The judicial action involves a bona fide issue; and (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

The issues resolved by the Settlement Agreement and Court order with respect to the nature of the beneficiaries' interests, when Trust will terminate, and what state law will apply to Trust are all bona fide issues regarding the administration of Trust and the construction of the terms of Trust. The Settlement Agreement is the product of arm's length negotiations and is within the range of reasonable outcomes under Trust and State law. Further, the Court's construction of Trust to resolve any ambiguities in the terms of Trust involves bona fide issues and is consistent with State law. Finally, the Settlement Agreement and Court order clarifying Trust will not shift a beneficial interest in the Trust to a lower generation beneficiary and will not extend the time for vesting of any beneficial interest in the Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the Court order interpreting Trust as including adopted children as "children" does not constitute a modification of Trust for purposes of § 2601 and resulting distributions from Trust consistent with this interpretation will not result in the loss of Trust's exempt status for purposes of the generations-skipping transfer tax and the Court order interpreting Trust as providing a life estate for Grandchild 2, with the remainder to Great-Grandchild 1 and Great-Grandchild 2, does not constitute a modification of Trust for purposes of § 2601 and resulting distributions from Trust consistent with this interpretation will not result in the loss of Trust's exempt status for purposes of the generation-skipping transfer tax.

Rulings ##3, 4, and 5

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident.

Section 2511 provides that the tax imposed by § 2501 will apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(c) of the Gift Tax Regulations provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes, depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-775 (9th Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, State law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the settlement reflects the result that would apply under State law. If there is a difference, it is necessary to

consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

The issues resolved by the Settlement Agreement and Court order with respect to the nature of the beneficiaries' interests, when Trust will terminate, and what state law will apply are all bona fide issues based upon valid enforceable claims by the interested parties. The Settlement Agreement and Court order reflect the results that would apply under State law, as described above. Therefore, based upon the facts presented and representations made, we conclude that the execution of the Settlement Agreement and approval of the agreement by Court; the Court order interpreting Trust to include adopted children as "children", and the resulting distributions from Trust consistent with this interpretation, and the Court order interpreting Trust as providing a life estate for Grandchild 2, with the remainder to Great-Grandchildren 1 and 2, and the resulting distributions from Trust consistent with this interpretation do not result in a gift by any party to the agreement.

Ruling #6

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

The rules of the State's Code apply to governing instruments executed prior to , "unless there is a clear indication of a contrary intent." Cite 2. Under State law, in construing the dispositive provisions of a transferor, an adopted child is included in class gifts, and, thereby, treated the same as a child by birth. Cites 3 and 4. Further, under State's Uniform Statutory Rule Against Perpetuities Act, the court may reform a disposition in the manner that most closely approximates the transferor's manifest plan of distribution that is with the 90 years allowed in the applicable sections in the Act. Cite 5.

Interpretation and construction of trust provisions are matters of state law. Because Court approved the interpretation of Trust, it is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries after modification to Trust will not differ materially from the interests in Trust. Court order merely clarifies Trust to remove ambiguity, provides definitive interpretation of Trust, and ensures Trust is not in violation of the rules against perpetuities in under State law. Accordingly, the proposed interpretation and modification of Trust will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is realized by the beneficiaries or Trust on the modification for purposes of § 1001(a).

Ruling #7

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

In the present case, Grandchild 2 has an interest in the income and principal of Trust during his lifetime. Grandchild 2 did not transfer the property to Trust and does not have any rights in the remainder in Trust. Accordingly, based upon the facts presented and representations made, we conclude that Trust is not includible in the gross estate of Grandchild 2 under § 2033.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, except as noted above, we are not ruling on the gift tax and income tax consequences of the transaction.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
(Passthroughs and Special
Industries)

Enclosure:

Copy of letter for section 6110 purposes